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Taxing our future: the burden of the Australian superannuation taxation system

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Abstract

This study provides an examination of the Australian superannuation system and demonstrates the onerous taxation burden applied to Australian superannuation contributions and earnings. Using Canada, New Zealand, the UK, and the USA as a basis for comparison, the superannuation schemes and supporting taxation systems of each of the five countries of the study are reviewed. A scenario is developed and applied that demonstrates the inequity of the Australian system relative to comparable nations. Given concerns about the ageing population, this research supports calls for further reforms to the taxation of superannuation in Australia, which highlight the need to make superannuation taxation policies more consistent with government efforts to encourage superannuation savings and self-funded retirement.

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Taxing Our Future: the Burden of the Australian Superannuation Taxation System

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ABSTRACT

This study provides an examination of the Australian superannuation system and demonstrates the onerous taxation burden applied to Australian superannuation contributions and earnings. Using Canada, New Zealand, the UK, and the USA as a basis for comparison, the superannuation schemes and supporting taxation systems of each of the five countries of the study are reviewed. A scenario is developed and applied that demonstrates the inequity of the Australian system relative to comparable nations. Given concerns about the ageing population, this research supports calls for further reforms to the taxation of superannuation in Australia, which highlight the need to make superannuation taxation policies more consistent with government efforts to encourage superannuation savings and self-funded retirement.

INTRODUCTION

A major demographic change faces Australians in coming decades with more growth in the retired population than in the number of people currently regarded as of working age (Barrett and Chapman, 2000; Piggott, 2004). While the post-war “baby boom” is the main contributing factor to the aging population, lifestyle preferences and medical advances mean that Australian’s are increasingly retiring younger and living longer (Barrett and Chapman, 2000).

In Australia, the response to the problem of population aging, and the inability of the social security system to support the aging population, is the Superannuation Guarantee scheme (SG) (Piggott, 2004). Introduced in 1992 under the *Superannuation Guarantee (Administration) Act 1992*, the SG requires employers to contribute a minimum level of superannuation support for each employee into a complying superannuation fund (Barrett and Chapman, 2000; Randell et al, 1996). The superannuation industry in Australia has since developed dramatically with around \$50 billion in assets currently under management and over ninety percent of employees covered by the superannuation system (Barrett and Chapman, 2000; McDonald et al, 2003). With the introduction of the SG, Australia led the way as one of the first developed economies to move from a system of unfunded national retirement schemes to a compulsory retirement savings scheme (Williams, 1996).

In 1994, the World Bank published a recommendation to assist countries in developing programs to minimize the adverse socio-economic and political consequences of population aging (Gavrilou and Heuveline, 2003). The recommendation advocated a model for national superannuation policy broadly representative of Australia’s system, known as the “three-pillar model” (Knox, 1996; World Bank, 1994). This model emphasises a move away from public pension arrangements and towards self-funded retirement (OECD, 1998).

The first pillar, common revenue, is a type of safety net, which provides social security retirement benefits that are not conditional upon past employment (Bateman and Piggott, 1996; Gollier, 2000). These pension systems are typically government funded and administered, and are subject to a means test with the aim of assisting lower income retirees (Barrett and Chapman, 2000; Bateman and Piggott, 1996). Deferred revenue comprises (often compulsory) employment related superannuation contributions which are accumulated during a retiree’s working life (Gallery, 2003; Gollier, 2000). Under the compulsory arrangements, a minimum level of employer contribution must be paid on behalf of all employees. The third pillar relates to saved income, that is voluntary retirement savings contributed to a superannuation or pension fund (Bateman and Piggott, 1996; Gallery, 2003). These voluntary retirement savings may be amounts contributed by an employer over and above that required

under the compulsory arrangements (Barrett and Chapman, 2000). Additionally, employees may elect to sacrifice a portion of their pre-tax salary as voluntary superannuation savings (Barrett and Chapman, 2000).

This study is intended to provide an examination of the Australian superannuation system and the taxation structure within which it is supported. To provide a basis for comparison, the Australian system will be compared to that of Canada, New Zealand, the United Kingdom (UK) and the United States of America (USA). These countries were selected because they are all OECD countries, have similar economic structures and systems and a broad cross section of taxation mechanisms. In addition, each has adopted a model similar to the three-pillar model for superannuation discussed above (Horne, 2002).

TAXATION TREATMENT OF SUPERANNUATION

While it is possible to tax superannuation at three points – when contributions are made to the fund, when earnings are made on the invested assets of the fund, and when benefits are paid out of the fund – Australia is the only OECD country that taxes superannuation at each of these three points (Bateman and Piggott, 1996; Gollier, 2000; Koch, 2004). Under the Canadian system and that of the UK and the USA, contributions made to pension plans are exempt from tax, as are earnings on the plan, with tax only incurred on the benefits paid out of the plan at retirement (OECD, 2001). New Zealand pension plans are taxed only when earnings are made on the fund, with both contributions and benefits tax exempt. Table 1 illustrates the taxation treatments of superannuation in each of the five countries of this study.

**Table 1: Taxation treatments of private pension systems of
Australia, Canada, New Zealand, the UK, and the USA**

Country	Contributions	Rate	Pension fund earnings	Rate	Pension payment income	Rate
Australia	Taxed + Surcharge	15% to 30%	Taxed	15%	Taxed	As income, with 15% rebate
Canada	Exempt		Exempt		Taxed	As income
New Zealand	Exempt		Taxed	33%	Exempt	
UK	Exempt		Exempt		Taxed	As income, with some exceptions
USA	Exempt		Exempt		Taxed	As income, but eligible for concessions

Horne, 2002

A Comparative Scenario

To demonstrate the taxation burden placed on Australian employees contributing compulsory and voluntary superannuation savings, a hypothetical scenario has been devised. For the purposes of the scenario, let us consider the case of a 50 year old man, who is a business professional earning the average wage, for this category of employee, of \$120,000 (www.michaelpage.com.au). His employer, in accordance with the Australian SG, contributes 9% of his income per year into the company's superannuation fund.¹ Let us assume that there are no additional contributions paid to the fund and that, annually, the fund averages earnings of 6.5% on the amounts invested. Finally, let us assume that this person intends to retire at the age of 65 and, according to Australian life expectancy rates, is expected to live until the age of 77 (www.abs.gov.au).

¹ This is the required contribution percentage as at 2003/04 financial year (Piggott, 2004).

To apply this scenario to the superannuation taxation systems of the five countries in the study, the variables income (\$120,000 per annum), employer contributions to the superannuation fund (9% per annum), and earnings on the fund (6.5% per annum) are held constant.² The superannuation taxation system of each of the study's country's are applied to these variables to determine the degree to which the tax treatment of superannuation in Australia is indeed more onerous than that of comparable nations. That is, with the variables of income, contributions and earnings held constant, the superannuation tax rates of Australia, Canada, New Zealand, the UK, and the USA are applied. The following formula was used to calculate the tax paid on superannuation contributions and earnings:

$$\text{Tax paid} = T_C (\text{INC} \times \text{CONT}) + T_E (\text{EC} \times (\text{INC} \times \text{CONT} - T_C (\text{INC} \times \text{CONT})))$$

Where,

INC	=	income
CONT	=	employer contributions
T _C	=	tax rate applied to contributions (including surcharge if applicable)
T _E	=	tax rate applied to earnings
EC	=	earnings on contributions

The results, which have been calculated for one year, are presented in Table 2.

Table 2: Taxation treatments of superannuation in Australia, Canada, New Zealand, the UK, and the USA: Applying the hypothetical scenario

		Australia	Canada	New Zealand	UK	USA
a	Salary p.a.	\$120,000	\$120,000	\$120,000	\$120,000	\$120,000
b	Employer contributions p.a. (at 9% of salary)	\$10,800	\$10,800	\$10,800	\$10,800	\$10,800
c	Tax paid on contributions p.a. (Australia - 15%)	(\$1,620)	\$0	\$0	\$0	\$0
d	Superannuation surcharge p.a. (Australia - 15%)	(\$1,620)	\$0	\$0	\$0	\$0
e	Net contribution p.a.	\$7,560	\$10,800	\$10,800	\$10,800	\$10,800
f	Earnings on contributions p.a. (at 6.5%)	\$491	\$702	\$702	\$702	\$702
g	Tax paid on earnings p.a. (Australia 15%, New Zealand 33%)	(\$74)	\$0	(\$232)	\$0	\$0
h	Net earnings p.a.	\$418	\$702	\$470	\$702	\$702
i	Net contributions and earnings to superannuation plan p.a.	\$7,978	\$11,502	\$11,270	\$11,502	\$11,502
j	Tax paid on contributions and earnings p.a.	(\$3,314)	\$0	(\$232)	\$0	\$0

Table 2 shows the tax that our illustrative tax payer would incur, for one year, on his superannuation contributions and earnings if his superannuation was taxed under the systems of each of our chosen five countries. Under the Australian system, a tax rate of 15% is applied to amounts contributed to the employee's superannuation (see row c in Table 2). In addition to this contributions tax, our employee will also incur a superannuation surcharge, which is an additional contributions tax phased in once income reaches \$94,961.³ Since our employee's income is above the surcharge threshold of \$114,981, the full amount of the superannuation surcharge, 15%, is also withheld from these contributions (see row d in Table 2). Hence, only 70% of the contributions made by the employer reach the employee's

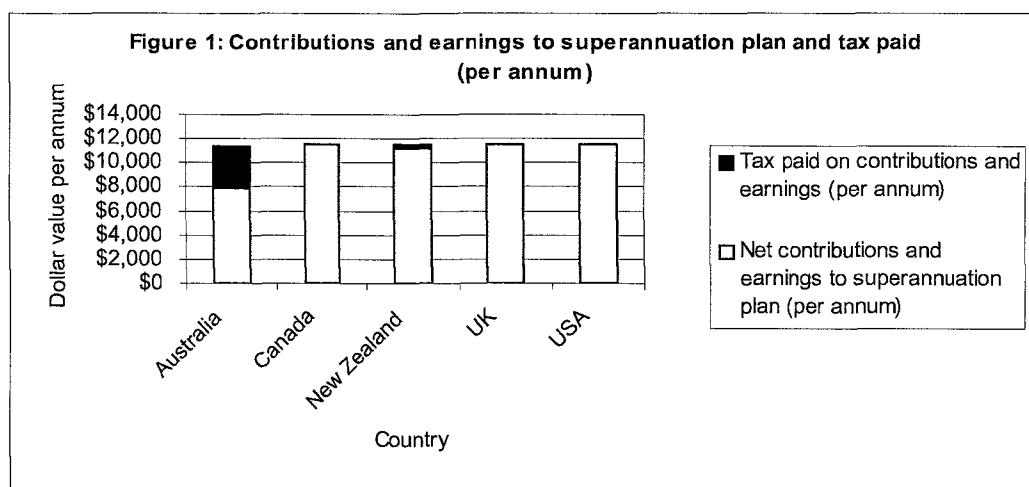
² The purpose of this scenario is to demonstrate the amount of tax paid on superannuation contributions and earnings. Hence, administrative fees and charges and inflation have been excluded from these calculations.

³ The amount of the surcharge increases at the rate of 0.001% of adjusted taxable income for every dollar earned above the lower threshold (\$94,691) until it reaches the upper threshold (\$114,981) when the maximum surcharge, 15%, is applied to superannuation contributions (<http://www.ato.gov.au>).

superannuation fund because of the tax rate of 30% applied to the contributions made on his behalf. Due to the tax withheld from the employee's contributions, the amounts invested will be less, which equates to a 30% decrease in earnings made on the fund. Moreover, the amounts earned on the invested contributions are also taxed at 15% (see row g in Table 2), thus further reducing the amount earned on the superannuation fund and thereby the amounts available for reinvestment.

The tax treatment of Australian superannuation funds compares unfavourably with that of the other countries of this study. As noted, Canada, the UK, and the USA do not withhold tax from contributed amounts or from amounts earned on superannuation investments (OECD, 2001). Consequently, applying the scenario to each of these countries shows that our employee would have an additional \$3,314 in his superannuation fund at the end of each year. Under the New Zealand system where taxes are incurred only when amounts are earned on the funds invested, our employee would pay just \$232 in tax on his superannuation contributions and earnings per year (see row g in Table 2) (OECD, 2001).

To illustrate effectively the impact of these various superannuation taxation structures, the net contributions and earnings made to the superannuation plan for each of the five countries of the study along with the corresponding taxation paid were graphed. The results are presented in Figure 1.



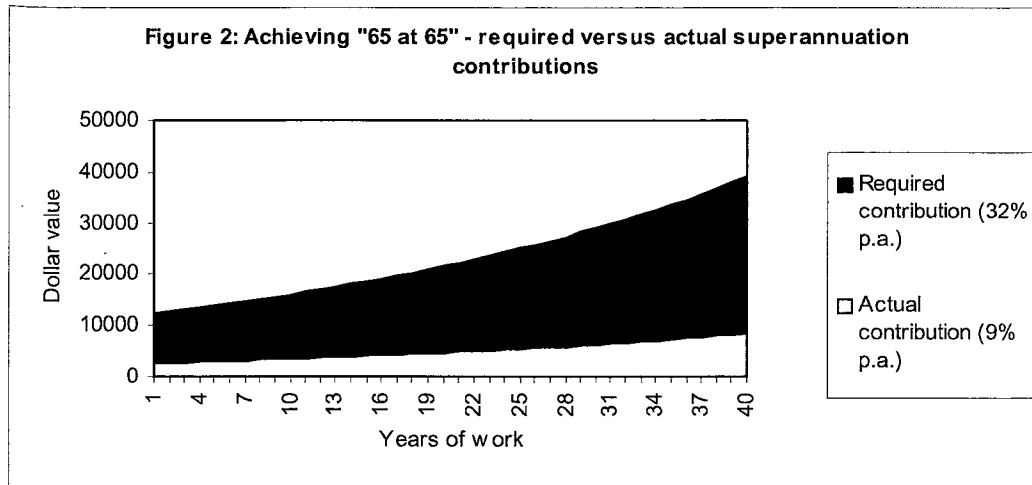
Extrapolating the effects of the various tax treatments of superannuation in each of the five countries, the amount that would have been available to our hypothetical employee on retirement was calculated.⁴ Under the Australian system, the employee would have a superannuation fund balance of almost \$193,000 available to him on retirement. Under the systems of Canada, the UK, and the USA, the superannuation fund balance would be approximately \$278,000, a considerably higher \$85,000. Under the New Zealand system, which taxes superannuation earnings only, approximately \$272,000 would be available to our employee.

Achieving the popularised goal of "65 at 65" – which means that retirement income at 65 will be 65% of final income (Lawrence, 2004) – is in fact an elusive target well outside the reach of the majority of Australians who rely solely on the nine percent superannuation contributions required under the SG. For example, assuming now that our employee enters the workforce at a starting salary of \$30,000 per annum and receives a three percent pay rise per annum compounded for forty years until retirement at 65, the employee's final salary will be approximately \$95,000. To meet the "65 at 65" target, the annual retirement income for this employee should be approximately \$62,000. If the retiree is to receive this level of income for twelve years,⁵ the balance of the superannuation fund at retirement needs to be roughly \$740,000, which equates to an annual contribution of approximately thirty two percent of salary. However, if only the mandatory contribution of nine percent of salary per year is

⁴ The calculation involved obtaining a future value of the net amount contributed to the superannuation fund each year, compounded at 6.5% for the 15 years between our employee's current age (50) and expected retirement age (65).

⁵ The retirement income must be available to the retiree for the 12 years between the age of retirement (65) and the life expectancy age of Australian males (77).

made to the fund, then the amount available in the superannuation fund on retirement will be just \$204,000, which allows a retirement income of roughly \$17,000 over twelve years. Figure 2 illustrates the amount of superannuation savings that are required to reach the target of "65 at 65", relative to the superannuation savings currently made by employees under the SG requirements, and highlights the inadequacy of current superannuation savings. The inadequacy of this amount will be even further exacerbated by the withholding of tax from the superannuation contributions and earnings.



DISCUSSION AND CONCLUSIONS

Despite the introduction of the SG in 1992, which lead to compulsory superannuation savings, there are fears that many Australians will be unable to support their retirement, instead continuing to rely on the government funded pension (ACCI, 2000). Those individuals who do not contribute voluntarily to their superannuation fund, that is, over and above the amounts required under the SG, are likely to face an inadequate savings base for retirement (ACCI, 2000). Therefore, the focus of Australian government policies has supposedly been on increasing measures that promote the self-funding of retirees to ensure that the retirement income system in Australia is viable in the long term (ACCI, 2000).

Although taxation concessions have been the primary incentive scheme used to encourage retirement savings, it is evident from this study that Australia's taxation of superannuation contributions and earnings is extremely onerous relative to the systems of our other four chosen countries. While Australian governments have espoused the view that superannuation taxation was never intended to be a revenue source, it is not difficult to see some merit in claims that superannuation taxes are in fact considered a "honey pot" of revenue with the Government collecting \$5.8 billion in superannuation taxes paid on contributions and fund earnings in 2003-04 (Laurence, 2004, p.13). It should be noted that since its introduction in 1997-98, the superannuation surcharge alone has collected \$4 billion in revenue (Laurence, 2004).

These authors join with other superannuation commentators in suggesting that Australian taxation policies as they relate to superannuation are in dire need of reform (Bateman and Piggott, 1996; Knox, 1996; Koch, 2004; Laurence, 2004; Piggott, 2004; Price, 1994). Indeed, a recent Senate Select Committee on Superannuation was formed to conduct an inquiry into "the adequacy of the tax arrangements for superannuation and related policy to address the retirement income and aged and health care needs of Australians" (Commonwealth of Australia, 2002, cited in Horne, 2002, p.2). This inquiry received one hundred and fifty two submissions containing various reform proposals (Horne, 2002). Reform suggestions often centre on the reduction of taxes on superannuation contributions and fund earnings and, recently, a reform package was passed which included tax cuts for high-income earners and superannuation co-contributions for low-income earners. The high-income earners will benefit in the form of a reduction in the superannuation surcharge, which will be phased in over the next three years to reduce the surcharge from fifteen percent to 7.5 percent (www.deloitte.com). However, even with this reduction in the surcharge, the employee in our scenario would still be paying \$2,430 in contributions tax per annum, \$810 of which is a result of applying the superannuation

surcharge of 7.5%. Considering that the other countries of our study do not tax superannuation contributions at all, the author's would argue that even the reduced rate is excessive. This most recent budget also offered a co-contribution of \$1,000 to the superannuation payments of low-income earners; to those earning less than \$27,500 per annum. With average Australian household debt at nearly \$14,000, excluding any growth in home loan debt, it has to be wondered if government seriously expects many earnings less than \$27,500 to be frugal enough to be able to put an extra \$1,000 after tax into their superannuation fund.

These reforms have been criticised for not providing benefits to the majority of Australians receiving average incomes (Koch, 2004). The reduction in the superannuation surcharge, for example, would mean little to those within ten years of retirement and affects only five percent of high-income-earning Australian employees (Laurence, 2004). To provide wider-reaching encouragement for superannuation savings, it has been suggested that the taxation on contributions should be eliminated altogether (Koch, 2004). Applied to our scenario, eliminating contributions tax, and therefore the contributions surcharge as well, would equate to an additional \$3,240 that would be available to the superannuation fund (row c plus row d in Table 2). Compounding this amount of tax withheld from superannuation contributions at the rate of 6.5% over fifteen years, an additional \$78,000 in retirement savings would be available to our employee upon his retirement as a result of eliminating contributions tax alone.⁶

Over the last two decades, the superannuation industry in Australia has shown dramatic growth. Projections now show that assets held in superannuation funds will reach a trillion dollars by mid-2010 (Nicholson, 2000). Such an increase, given the current draconian tax system, as it currently applies to superannuation in Australia, can only mean that future governments can be assured of an ever increasing source of revenue. When will governments realise that superannuation should be used to fund retirement and not treated as a primary source of tax income? The current liberal government, despite some limited revision for higher salary contributions in the May 2004 Federal Budget, seems set to continue with "its addiction to maintaining the total tax take at around a quarter of GDP" (The Australian, 12 May, 2004).

The Labour opposition has stated that, should it gain government at the upcoming election, it would start to phase out the superannuation contributions tax. However, this is envisaged to happen over a number of parliamentary periods. The simple truth is that neither of the two main Australian political parties are seriously intent on addressing the inadequacy of the retirement savings of those over forty years of age. The savings gap is not likely to go away in the foreseeable future.

As Wyatt (2004) has stated:

"Most people within 25 years of retirement have grossly inadequate super and it is quickly getting too late to help them. It is already too late to do much for someone with just five to ten years left to go at work" (cited in Lawrence, 2004, p.12).

Front loaded contributions taxes are counterproductive to encouraging Australians to plan for self-funded retirement. It would be far better to let contributions invested by being compounded forward and then tax future superannuation benefits at a fair marginal rate once the contributor retires. Such an approach would save money, encourage greater investment, and drastically reduce the complexity of the current tax system.

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⁶ This amount is calculated as the future value of the amount of contributions tax withheld per annum (\$3,240), compounded at 6.5% p.a. for the 15 years between our employee's current age (50) and expected retirement age (65).

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